

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE JOINT APPLICATION OF THE SALYERSVILLE )	
GAS COMPANY, INC. AND WILLIE J. SMITH AND )	
R. D. WILLIAMS FOR THE APPROVAL OF THE )	CASE NO. 89-251
ACQUISITION OF THE SALYERSVILLE GAS )	
COMPANY, INC. BY WILLIE J. SMITH AND )	
R.D. WILLIAMS )	

O R D E R

By joint petition filed September 5, 1989 the applicants Willie J. Smith, Richard D. Williams ("Purchasers") and Salyersville Gas Company, Inc. ("Salyersville") requested the Commission approve the sale and transfer of the Salyersville system to the Purchasers. Also submitted for review were the Contract of Sale setting forth the terms of the transaction and personal financial data of the Purchasers. All information requested by the Commission has been filed and the notice of adoption of rates as required by 807 KAR 5:011, Section 11 was filed along with the application.

KRS 278.020(4) provides that the Commission shall approve the transfer "... if the person acquiring the utility has the financial, technical and managerial abilities to provide reasonable service." The Commission has reviewed the joint application applying the standard set forth by statute, however, as this case arose from a case pending on the Commission's docket,

Case No. 89-174,<sup>1</sup> and the information provided by the parties to support the statutory standard is relevant to both proceedings, the Commission believes it expedient to incorporate the record of this case into Case No. 89-174.

#### Financial Considerations

The Purchasers individually provided financial data disclosing their personal holdings and further disclosing their holdings in corporate and other business entities. After a review of the information, the Commission is satisfied that the Purchasers have demonstrated adequate financial expertise to provide reasonable service.

However, the Commission has serious concerns regarding the economic feasibility of this transfer. The Commission is concerned that, without a substantial increase in rates because of the large purchase price and the additional debt incurred by the Purchasers, the Purchasers will not be able to operate the system on a sound financial basis. The Commission is further concerned that such an increase in rates would be detrimental to the financial stability of Salyersville and, therefore, detrimental to its ratepayers. In the alternative, the Purchasers will not recover the investment above the depreciated original cost of the utility, which would result in a substantial loss to Purchasers.

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<sup>1</sup> Case No. 89-174, Failure of Salyersville Gas Company to Comply With Commission Regulations and to Furnish Adequate, Efficient and Reasonable Service

As prescribed by the Uniform System of Accounts, Gas Plant in Service, (Account 101) is to be recorded at original cost. Rate-making treatment generally allows for the recovery of the original investment. If the sale of a utility results in a purchase price that is greater than the original cost less accumulated depreciation ("net book value"), the difference between the purchase price and the net book value is accounted for as a plant acquisition adjustment. The plant acquisition adjustment is booked into a separate account and amortized over the useful life of the related plant or as otherwise directed by this Commission.

The purchase price agreed upon in this case is \$1,200,000. Based on the Annual Report filed with this Commission, Salyersville's net book value at December 31, 1988 was \$403,078, thus, the plant acquisition adjustment is approximately \$797,000. If in some later proceeding the Commission were to allow the acquisition adjustment to be recovered through rates, it would require an approximate 34 percent increase in rates. If Salyersville increased its rates by this amount, it would follow that there would be a substantial decrease in sales, resulting in a loss of revenue which would necessitate another rate increase, and so on.

In this proceeding the Purchasers have indicated that the transfer will not be recorded on Salyersville's books but will be accounted for as a personal transaction between the Purchasers and Salyersville's owners.<sup>2</sup> Under cross examination, applicant

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<sup>2</sup> Transcript, October 31, 1989, page 43.

Williams stated that the \$1.2 million purchase price was determined based upon what the sellers asked, and what the Purchasers thought to be a fair price. Mr. Williams also stated that the financing terms, [which, among other things, provided for no payment of the principal owed to the seller for 5 years], were a major factor in the determination of the sale price.<sup>3</sup> Under further cross examination, Mr. Williams stated that he and his partner could operate the system and keep it on a sound financial basis without a rate increase.<sup>4</sup> Mr. Williams feels that this is possible for several reasons. The first is that the Inland pipeline is now open access and that there would now be a firm supply of gas for the community.<sup>5</sup> Secondly, Salyersville could attract new industry in addition to selling gas to the present industries that are not using gas. Third, there is a substantial number of residential customers that could be acquired.<sup>6</sup> Finally, Mr. Williams stated that Mr. Smith and he are willing to commit the necessary resources to keep the system operating and would do so for up to 10 years if necessary.<sup>7</sup>

In response to the Purchasers' optimistic outlook with regard to their ability to operate Salyersville on a sound financial

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<sup>3</sup> Id., page 42.

<sup>4</sup> Id., page 47.

<sup>5</sup> Id.

<sup>6</sup> Id., pages 45-46.

<sup>7</sup> Id., page 47.

basis without a rate increase, the Commission notes that in the regulated utility environment in which Salyersville operates, the opportunity to recover investment above the depreciated original cost may not exist. In fact, there are factors which would severely limit the ability of the Purchasers from recovering their investment even if additional customers and sales are added. For instance, it is the responsibility of the Commission to make certain that a utility does not charge excessive rates. The Commission utilizes rate base regulation for private utilities and a return is allowed on the reasonable investment in utility plant devoted to providing service to the customers of the utility. In this case, no additional investment is required to continue the level of service now provided. However, upon the transfer of Salyersville to its new owners at the proposed \$1.2 million price, an additional investment of approximately \$797,000 is made in the same utility. This additional investment is not providing any additional utility plant in service. Consequently, in future rate cases, the burden would be on the utility to show that the additional investment was not excessive and in the best interests of the utility. The Purchasers have indicated that they do not propose to include the plant acquisition adjustment on the books of Salyersville. If the plant acquisition adjustment is not allowed in rate base, there is no means for the investors to recover this cost. Even if new customers are added to the system, the rate base on which the investors are allowed to earn a return is the depreciated original cost. Thus, as sales increase, the earnings of the utility do not.

Even if the Purchasers succeeded in obtaining the Commission's approval in the future to recover the plant acquisition adjustment in rates, the increase in rates could cause decreases in usage and revenue losses which would totally offset any additional revenues obtained through a rate increase. If the Purchasers attempted to recover this additional investment through the wholesale cost of gas, the same result could be realized.

The Purchasers have indicated that they can operate the system without increasing rates to recover the costs of this transfer, the acquisition adjustment, or the cost of additional debt and the Commission has indicated that it is possible that future recovery through rates of the entire investment, may most likely not be allowed. The Commission cannot by law deny approval of the transfer because of the disparity between the purchase price and the net book value of the system.<sup>8</sup> Therefore, the Commission finds that Purchasers have demonstrated that they have sufficient financial resources and expertise to continue to provide reasonable service to the customers served by the Salyersville system.

#### Managerial and Technical Considerations

Based upon the information provided in the Application and in their response to the Commission's October 6, 1989 information request, Messrs. Williams and Smith have 20 years experience in gas and oil production and with the installation and management of

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<sup>8</sup> Bluegrass State Telephone Company v. Public Service Commission, Ky., 382 S.W.2d 81 (1964).

pipelines. While the prospective owners have no experience in operating a local distribution company, they will continue to employ all meter readers and personnel involved in customer billing and related maintenance and service activities who are now employed by Salyersville.<sup>9</sup> In addition, Messrs. Williams and Smith are currently operating gas gathering systems which provide gas to the city of Livingston, Tennessee;<sup>10</sup> have a franchise with the city of Celina, Tennessee to provide gas;<sup>11</sup> and operate a gas gathering system in Clinton County, Kentucky which provides gas to Albany, Kentucky.<sup>12</sup> Based upon the above, the Commission is satisfied that the prospective Purchasers have demonstrated adequate managerial and technical expertise to continue to provide reasonable service to those customers served by Salyersville.

The managerial and technical expertise of the Purchasers related to the procurement of a long-term, reliable gas supply for Salyersville is also of paramount importance to the Commission due to the following. The Commission has initiated two previous show cause proceedings, each of which was precipitated by service disruptions to some of Salyersville's gas customers. In Case No. 9200<sup>13</sup> service disruptions occurred during the 1984-85 heating

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<sup>9</sup> Tr., page 56.

<sup>10</sup> Tr., page 41.

<sup>11</sup> Response to Question 6 of Commission Order, October 6, 1989, page 6.

<sup>12</sup> Ibid., page 7.

<sup>13</sup> Case No. 9200, An Investigation Into the Natural Gas Supply Available to the Salyersville Gas Company.

season. An August 8, 1985 Order dismissed the proceeding after Salyersville presented information to show that three additional wells had been interconnected with the Salyersville system.

Case No. 89-174, currently pending before the Commission, was established July 10, 1989 following submission of a Staff Report which reviewed Salyersville's operations. The Staff Report included a review of Salyersville's current sources of gas supply and the extent to which long-term, reliable sources of supply are available for future gas needs. Staff's review was precipitated by a series of service disruptions experienced by a portion of Salyersville's gas customers in December 1988 and February 1989. According to the Staff Report, Salyersville has had to purchase emergency supplies of gas from Inland Gas Company ("Inland"), an interstate gas pipeline, during 1986, 1987, twice in 1988, and 1989. At the hearing on Case No. 89-174, held October 31, 1989, Salyersville requested the Commission continue the hearing generally in order to pursue selling the system. The instant case was then established based upon the application for approval of the sale. The predominate issue in 89-174 was whether Salyersville had secured a long-term reliable source of gas.

Based upon its 1988 Annual Report filed with the Commission, Salyersville sold 22,699 Mcf to 257 customers. The sources of supply and the amount purchased from each was:

Cobra Oil and Gas	17,176 Mcf
R. C. Energies	801 Mcf
Tricor	2,282 Mcf
Inland Gas Company	1,427 Mcf
AEI-KAARS	1,013 Mcf

Mr. Williams testified that he has reviewed Salyersville's gas



purchases for 1988,<sup>14</sup> and estimates that Salyersville's peak needs during the 1988-89 heating season were 200 Mcf per day. He estimates Salyersville's peak needs for the 1989-90 heating season to be 250 Mcf per day, with the increase based upon connecting new customers to the system. Mr. Williams has also estimated that Salyersville's gas purchases for the 12-month period proceeding his assumption of ownership will be 30,400 Mcf.

Mr. Williams also testified that gas purchase contracts with existing suppliers will be honored, if the supplier wishes and if the gas provided is pipeline quality.<sup>15</sup> Additional gas supply required by Salyersville will be provided by Centran Corporation ("Centran"). According to Andrew Fellon, manager of Energy Marketing for Centran, Mr. Williams and Centran are currently negotiating and have agreed in principle to a gas supply contract which would allow Salyersville to purchase up to 1,000 Mcf per day. The proposed contract provides no minimum purchase requirement;<sup>16</sup> a fixed term of five years, December 1, 1989 through November 30, 1994;<sup>17</sup> and selection of either a fixed price for gas or a price tied to a monthly index.<sup>18</sup>

Given the apparent flexibility inherent in the Centran contract regarding gas volumes available for purchase by

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<sup>14</sup> Transcript, October 31, 1989, page 36.

<sup>15</sup> Tr., pages 50, 56.

<sup>16</sup> Tr., page 68.

<sup>17</sup> Tr., page 11.

<sup>18</sup> Tr., page 64.

Salyersville, the Commission notes that the effect is such that any disruptions in supply from Salyersville's existing suppliers should be more than compensated by additional purchases through Centran. Based upon testimony by Mr. Williams<sup>19</sup> and Mr. Fellon,<sup>20</sup> the anticipated price for gas provided by Centran will be competitive with Salyersville's existing cost of gas of \$3.10.

Gas purchases from Centran will be provided through displacement to Salyersville through existing lines of Inland which are connected to the Salyersville system.<sup>21</sup> Centran will bring gas through either Columbia Gas Transmission ("TCO") or Tennessee Gas Transmission pipelines, then inject the gas into Inland's system. This gas will be displaced with existing production from the region on the southern end of Inland's system; thus, gas from local production will be supplied to Salyersville. Supply of gas through the Inland system became possible August 1, 1989, when Inland received a Certificate of Public Convenience and Necessity from the Federal Energy Regulatory Commission to operate as an open access pipeline and transport third-party gas on a nondiscriminatory basis.<sup>22</sup>

Since the portion of Salyersville's gas purchases provided by Centran will be transported through an interstate pipeline the Commission is of the opinion that these gas supplies should be

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<sup>19</sup> Tr., page 20.

<sup>20</sup> Tr., page 65.

<sup>21</sup> Tr., pages 29, 67.

<sup>22</sup> Tr., page 47.

provided on a firm basis. While Mr. Williams testified that the Centran contract will be for a firm supply, Mr. Fellon stated that firm transportation on the TCO system will not be available until sometime in the fourth quarter of 1990.<sup>23</sup> Until that time transportation of third-party gas on TCO could be subject to interruption if capacity constraints occur on the TCO system.

According to Mr. Fellon, TCO has never been at full capacity, i.e., its pipelines have never been unable to accommodate additional gas, although there have been periodic curtailment problems for third party gas due to "paper problems."<sup>24</sup> Since Salyersville's customer base is predominantly residential Mr. Williams should acquire a firm transportation arrangement through Centran for any gas purchases it provides for Salyersville's system supply. This is particularly crucial given Salyersville's history of inadequate supply from its historical suppliers. Mr. Williams should advise the Commission when firm transportation has been included in its contract with Centran.

Salyersville should be advised that it should amend its purchased gas adjustment clause to make current the listing of supplier and rate per Mcf. All future changes in wholesale supplier or wholesale rate should be filed with this Commission in accordance with the purchased gas adjustment clause as set out in Salyersville's tariff.

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<sup>23</sup> Tr., page 62.

<sup>24</sup> Tr., page 63.

### ENGINEERING ISSUES

As stated herein, Salyersville will be purchasing gas from Centran through existing lines of the Inland system. Messrs. Williams and Smith are currently negotiating the purchase of a portion of the Inland system, including the pipeline which is directly connected to the Salyersville system. Approval of this transaction for the purchase of a portion of the Inland system does not fall within this Commission's jurisdiction since the Inland system is regulated at the federal level.

This purchase will include ". . . everything west of the main north and south trunk line . . . that's in Magoffin County, approximately 22 miles(s) of six inch steel line . . . (and) an additional four inch line and some wells and some leases for an additional \$15,000 to \$25,000 more . . . ."25 Mr. Williams anticipates that once the title work is completed the purchase will be finalized. The purchase will be made in the name of BTU, Inc. ("BTU"), of which the principals are Messrs. Williams and Smith. Mr. Williams testified that BTU will not assess Salyersville a transportation charge for delivery of gas through its lines.26

Mr. Williams testified that the Inland lines to be purchased are currently operating at 50 to 60 pounds per square inch gauge

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25 Tr., page 14.

26 Tr., page 28.

("psig"), but expects to increase the pressure at times to approximately 75 psig to assist the movement of gas through the Inland lines to Salyersville.<sup>27</sup> His intention is to upgrade these lines where needed, and he is willing to conduct a pressure test on the Inland lines to be purchased if such test is required by the Commission.<sup>28</sup>

Subsequent to the October 31, 1989 hearing in Case No. 89-174, Inland filed with the Commission additional information on the pipelines proposed to be sold. Based upon this information, the main line, G-39, consists of several miles of six- and eight-inch lines originally constructed in 1946. This pipeline is Dresser coupled, and over the years several small sections have been replaced. In addition, several other feeder lines that connect to line G-39 will be sold. These lines are also Dresser coupled, were constructed subsequent to G-39, and for the most part are of late 1940's vintage.

According to Inland, for the past several years these lines have been operated at pressures ranging from 25 to 50 psig and have been patrolled at least once each year. Any leaks discovered during these patrols were repaired. Leak reports from 1986 and thereafter were also filed with the Commission.

Based upon the testimony of Mr. Williams and the information submitted by Inland, it appears that the Inland lines to be

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<sup>27</sup> Tr., pages 24-25.

<sup>28</sup> Tr., pages 26-27.

purchased will continue to operate as gathering lines. However, while the operational status will be as gathering lines, BTU will be a transporter of gas to Salyersville. As a transporter, BTU will be subject to and should comply with the requirements of the Commission Order in Administrative Case No. 297.<sup>29</sup>

The Commission has reviewed the leak reports submitted by Inland and notes that virtually all of the leaks have been corrosion-related. The Commission is of the opinion that since most of the leaks were corrosion-related, the remaining portions of the lines have some degree of corrosion as well. Therefore, BTU should conduct a leak survey over all of the Inland lines referenced herein within 12 months of their purchase. Within 30 days of the results of the survey, BTU should submit to the Commission for approval a proposed maintenance plan to be implemented which describes the number and type leaks found. The nature of repairs to be made, the type of program to be implemented to monitor on-going corrosion, and what sections of pipe will be replaced.

After review of the application and the evidence of record and being otherwise sufficiently advised the Commission finds:

1. The record in the instant case should be incorporated in its entirety into the record of Case No. 89-174 since the managerial and technical expertise in operating this system

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<sup>29</sup> Administrative Case No. 297, An Investigation of the Impact of Federal Policy on Natural Gas to Kentucky Consumers and Suppliers

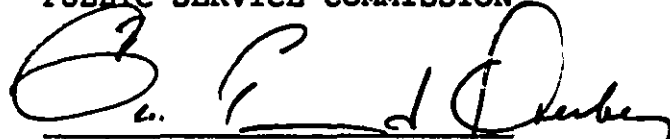
overlaps with the issue of Salyersville ability to secure a long-term reliable source of gas.

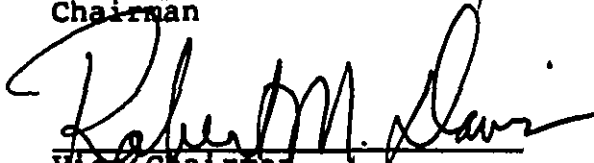
2. The Purchasers possess the requisite financial, managerial and technical expertise to provide reasonable service to the customers served by Salyersville.

IT IS THEREFORE ORDERED that the transfer of Salyersville from its present owners to the Purchasers be and it hereby is approved.

Done at Frankfort, Kentucky, this 1st day of December, 1989.

PUBLIC SERVICE COMMISSION

  
Chairman

  
Vice Chairman

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Commissioner

ATTEST:

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Executive Director